# Death and Survivor Benefits Tax Information

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## Overview

This bulletin summarizes the tax rules that may apply to your survivor benefit payment. These rules are complex and contain many conditions and exceptions that are not discussed in this bulletin. Therefore, you may want to consult a professional tax advisor, particularly if you have choices concerning the payment of your benefit.

More specific information on the tax treatment of your payments from TRS is available in the following Internal Revenue Service (IRS) publications:

- IRS Publication 575, *Pension and Annuity Income*
- IRS Publication 590, *Individual Retirement Arrangements*
- IRS Publication 559, *Tax Information for Survivors, Executors and Administrators*

These IRS publications are available from your local IRS office, at www.irs.gov, or by calling (800) TAX-FORMS.

## Payment of Accumulated Contributions

**General Rule**

Previously taxed accumulated retirement contributions returned to survivors of TRS members are excluded from taxable income. Contributions not previously taxed and interest on contributions are included in taxable income in the calendar year the contributions and interest are received by the beneficiary. The taxable portion of the payment is treated for tax purposes the same as ordinary income, unless one of the following special tax treatments applies.

**Special Tax Treatments**

The payment may be eligible for special tax treatments if it qualifies as a lump-sum distribution. A lump-sum distribution is a payment, within one calendar year, of the entire amount payable from TRS on account of the deceased member. The special tax treatments are not available, however, if any portion of a distribution from TRS has been rolled over. Additional restrictions are described in the instructions to IRS Form 4972.

The special treatments available for payments that qualify as lump-sum distributions are:

(1) **10-Year Averaging.** If the deceased member had attained age 50 before January 1, 1986, the beneficiary may be able to figure the tax on the payment using the 10-year averaging method using 1986 tax rates.

(2) **Capital Gain Treatment.** If the deceased member had attained age 50 before January 1, 1986, the beneficiary may be able to elect to have the part of the payment that is attributable to the member's pre-1974 membership (if any) taxed as long-term capital gain at a rate of 20 percent.

**Rollover**

A beneficiary who is a surviving spouse of a member may elect a rollover of the taxable portion of a payment and thereby defer taxation until the amount rolled over is later received. If you are the deceased member's surviving spouse, you can make a rollover by either requesting TRS to make a direct rollover or by electing to receive the payment and then rolling it over yourself. Rollovers are not available to non-spouse beneficiaries.

Surviving spouses should read the "Rollovers by a Surviving Spouse" and "Mandatory Federal Tax Withholding" sections of this bulletin. These sections provide important information about rollovers and the requirement that federal tax be withheld at a rate of 20 percent if a **direct** rollover is not requested.

## *Survivor Benefits*

**Monthly Annuity Payments**

Survivor benefits that are paid in the form of a monthly annuity are taxable income in the calendar year during which they are received by the beneficiary. However, if the member's contributions for survivor benefits had been made on an after-tax basis, a portion of each annuity payment will be nontaxable until all of the after-tax contributions have been returned. The nontaxable portion of each monthly payment is determined by allocating a portion of the after-tax contributions to each annuity payment to be made during the expected payment period. Monthly payments are fully taxable after all of the after-tax contributions have been returned.

**Single-Sum Payment**

The rules summarized above that apply to payment of accumulated contributions also apply to survivor benefits paid in a single sum.

## *Rollovers by a Surviving Spouse*

If you are a surviving spouse and you are to receive a single-sum payment of accumulated contributions, survivor benefits, or both, you can elect to roll over the taxable portion of the payment. A rollover is a payment of your taxable benefit to an eligible employer plan or IRA . A rollover can be made in two ways — you can have TRS make the rollover by paying your benefit directly to the eligible employer plan or IRA (this is referred to as a direct rollover) or you can receive the payment and later make the rollover yourself.

If a direct rollover is not elected, the amount that could have been directly rolled over will be subject to mandatory 20 percent federal income tax withholding requirements.

**Direct Rollovers**
Surviving spouses who are entitled to receive a payment eligible for rollover can elect a direct rollover. In a direct rollover, TRS pays the taxable portion of the payment directly to an eligible employer plan or an IRA on behalf of the surviving spouse. The amount rolled over is taxed when it is distributed from the plan or IRA.

Direct rollovers are subject to the following limitations:

- The nontaxable portion of a payment cannot be rolled over. For this reason, the nontaxable amount automatically will be paid directly to the surviving spouse. The nontaxable amount is not subject to withholding requirements.
- If the taxable portion of the payment is more than $500, the surviving spouse may elect to receive part of the payment and have the balance directly rolled over into an eligible employer plan or IRA. However, the direct rollover must be at least $500.
- If the taxable portion of the payment is less than $500, the surviving spouse must either receive 100 percent or have 100 percent of the taxable portion directly rolled over.
- Only one direct rollover recipient can be designated by the surviving spouse.

Before initiating a rollover, TRS members need to confirm the rollover with their financial entity. Restrictions may apply. TRS makes every effort to process direct rollovers quickly. We cannot pay interest on delayed payments.

If a surviving spouse wants a direct rollover, he or she must complete a Dependent Beneficiary and Spouse's Survivor Benefits Election form. This form includes a direct rollover election and the required certifications (by the surviving spouse and the receiving financial institution). If the direct rollover election is not completed, TRS will assume that the surviving spouse has elected to receive the payment and have 20 percent withheld for federal income tax.

**If a Direct Rollover is Not Elected**
If the surviving spouse elects to receive all or a portion of the payment, the taxable amount received is subject to 20 percent federal income tax withholding. For example, if the surviving spouse is entitled to a taxable payment of $10,000, only $8,000 will be paid because TRS must withhold $2,000 to pay income tax. However, when the surviving spouse prepares his or her tax return, the full $10,000 will be reported as the taxable payment. The $2,000 will be reported as tax withheld, and it will be credited against any income tax owed for that year.

If a surviving spouse receives a payment that could have been directly rolled over to an eligible employer plan or IRA, the surviving spouse can still decide to roll over all or part of the taxable portion of the payment (including the amount withheld if the surviving spouse has other funds available). However, the rollover must be within 60 days after the date the surviving spouse received the payment.

For example, assume the surviving spouse is eligible to receive a taxable distribution of $10,000 and elects to receive the entire amount. The surviving spouse will actually receive only $8,000 because $2,000 (20 percent) must be withheld for federal income tax. Within 60 days after receiving the payment, the surviving spouse may elect to roll over the entire $10,000 to an eligible employer plan or IRA. To make the rollover, the surviving spouse must find $2,000 from other sources (*e.g.,* savings, loan). In this case, the entire $10,000 is not taxed until it is taken from the IRA.

On the other hand, if the surviving spouse had rolled over only $8,000, the $2,000 is taxed the year it was withheld.

### *Mandatory Federal Tax Withholding*

Single-sum payments to be made to the surviving spouse of a deceased member are subject to 20 percent withholding for federal income tax. The only way a surviving spouse can avoid the mandatory withholding on these payments is to elect that the taxable portion of the payment due be directly rolled over to an IRA. Monthly annuity payments are not subject to the 20 percent mandatory withholding requirement; however, they are subject to the voluntary withholding rules described below.

### *Voluntary Federal Tax Withholding*

The following payments are subject to voluntary federal income tax withholding:

- monthly annuity or single-sum payments made to beneficiaries who are not spouses.
- monthly annuity payments to surviving spouses.

Beneficiaries can elect that federal income tax not be withheld from the monthly annuity payments by completing and filing with TRS Form W-4P, IRS Withholding Certificate for Pension or Annuity Payments. TRS is required to withhold federal income tax unless the beneficiary has elected that no withholding be made.

Single-sum payments made to surviving spouses are subject to mandatory withholding rules if they are not directly rolled over.

### *Tax Reporting for All Payments to TRS*

The Office of the Comptroller will send the beneficiary and the IRS a report (Form 1099-R) on the amount paid (including direct rollovers) during the calendar year. In addition to showing the amount paid, Form 1099-R will report the portion that is taxable and the amount of federal income tax withheld, if any.

### *State Income Taxes*

Benefits received from TRS are not subject to Illinois Income Tax. Beneficiaries who reside in other states should check with their state taxing authority for information concerning the taxability of benefits.

*This publication is provided with the understanding that it is a source of information and does not constitute legal, tax, or other professional advice. If legal advice or other professional assistance is required, the services of a competent, professional advisor should be sought.*



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